The Federal Reserve Board

Minutes of the Federal Open Market Committee

Meeting of May 20, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 20, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Meyer
Mr. Moskow
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Conrad, First Vice President, Federal Reserve Bank of Chicago

Messrs. Dewald, Hakkio, Ms. Krieger, Messrs. Lang, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, New York, Philadelphia, Dallas, and Cleveland respectively

Messrs. Cox, Rosengren, and Weber, Vice Presidents, Federal Reserve Banks of Dallas, Boston, and Minneapolis respectively

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By unanimous vote, the Federal Open Market Committee approved the minutes of its meeting on March 25, 1997.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. The Desk did not conduct any transactions in foreign currencies for System Account during the period since the latest meeting on March 25, 1997, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 25, 1997 through May 19, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the expansion of economic activity had slowed after having surged in late 1996 and earlier this year. Consumer spending appeared to be increasing at a considerably slower pace after the spurt in the first quarter, while business fixed investment remained on a strong uptrend, and the demand for housing seemed to be well maintained. Growth of labor demand had moderated somewhat from the rapid pace at the beginning of the year, but labor markets remained tight and worker compensation appeared to be accelerating gradually. Despite the upward drift in labor costs, underlying price inflation was still subdued.

Private nonfarm payroll employment rose at a considerably reduced pace over March and April, and the average workweek dropped from an unusually high rate in February and March to a more normal level in April. The services industries recorded further large gains in employment in March and April, but the number of jobs in manufacturing contracted in April and construction employment declined in both March and April. The civilian unemployment rate fell appreciably in April to 4.9 percent, and the labor force participation rate edged down from the record high reached in March.

Industrial production was unchanged in April after having recorded sizable increases in March and other recent months; declines in mining and manufacturing were offset by a large rise in utility output. The drop in manufacturing production reflected a sharp decline in the output of motor vehicles and parts that was largely related to the lagged effects of strike activity in recent months. The output of manufactured goods other than motor vehicles and parts rose moderately in April: the production of business equipment posted another solid gain while the output of consumer goods and construction supplies was unchanged. The rate of utilization of manufacturing capacity fell in April, reflecting the decline in motor vehicle output, but it remained relatively high.

Nominal retail sales were unchanged in March and declined in April after having increased rapidly in earlier months. Weaker sales of motor vehicles contributed to the overall sluggishness of retail activity in March and April, but spending on many other categories of goods, both durable and nondurable, also was down over the two-month period after having previously grown strongly. Expenditures on services advanced further through March (latest available data) even though unseasonably mild weather held down outlays for heating. While retail sales had slowed recently, the latest surveys indicated that consumer sentiment had risen further from an already markedly high level.

Housing activity in March and April was in line with that in other recent months. Single-family housing starts were unchanged in April after declining in March. Starts for the two-month period were only a little below the average for 1996, and sales of new homes remained at a very high level in March (latest data). Multifamily starts rose considerably in April and on average over March and April were a little above the elevated level in the fourth quarter.

Business fixed investment expanded briskly in the first quarter. Outlays for producers' durable equipment rebounded after fourth-quarter weakness, and spending for nonresidential structures posted another substantial advance. Available indicators pointed to further sizable gains in spending on both equipment and structures. Business inventory investment was up considerably in the first quarter after increasing by a relatively small amount in the fourth quarter; however, inventory-sales ratios for most industry and trade groupings remained at very low levels.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over January and February from the temporarily depressed rate in the fourth quarter of last year and was about the same as the rate in the third quarter. A surge in imports reflected a rebound in the importation of automotive products from the strike-reduced level of the fourth quarter, further expansion in purchases of imported computers, and an upturn in imports of semiconductors after four quarters of declines. By contrast, exports of goods and services rose only slightly in the January-February period; exports of automotive products were up sharply, but sizable increases in exports of chemicals, computers, and semiconductors were largely offset by declines in other non-automotive trade categories. Recent economic information on the foreign G-7 countries, including some preliminary indicators for the second quarter, suggested that the growth of output had strengthened somewhat on average in these countries. Activity in continental Europe, though still weak, was improving, while the economies of Canada, Japan, and the United Kingdom remained strong. Economic activity continued to expand rapidly on average in the major developing countries in the first quarter.

Recent data indicated that price inflation remained moderate despite a gradual acceleration of labor costs. Increases in consumer prices were held down in March and April by sizable declines in energy prices and a small net reduction in food prices. Consumer prices for items other than food and energy advanced at a moderate rate over the two months, and over the twelve months ended in April they increased by the same amount as in the previous twelve months. Producer prices fell in both March and April, reflecting large declines in energy prices. Excluding food and energy, producer prices edged lower in April after rising a sizable amount in March. Core producer prices increased considerably less over the twelve months ended in April than over the previous twelve months. At earlier stages of production, producer prices registered declines both in recent months and for the twelve months ended in April. An upward creep in the growth of labor costs was apparent in data on the hourly compensation of private industry workers; although the rise in the first three months of 1997 was smaller than the increase in the fourth quarter, the advance over the twelve months ended in March was larger than that over the previous twelve months. A similar but more pronounced pattern was evident in data on average hourly earnings for production or nonsupervisory workers.

At its meeting on March 25, 1997, the Committee issued a directive that called for a slight increase in the degree of pressure on reserve positions; the firming of policy was taken in light of continued rapid growth of aggregate demand in the first quarter and the attendant greater risk of heightened pressures on resources and an upturn in inflation. Although further policy tightening might be needed at some point, the Committee did not believe that developments during the intermeeting period were likely to require an adjustment, and thus the directive did not include a presumption about adjustments to policy during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Open market operations immediately after the meeting on March 25 were directed toward implementing the slightly firmer reserve conditions desired by the Committee and then maintaining those conditions over the remainder of the intermeeting period. The federal funds rate averaged close to the higher intended level of 5-1/2 percent. Open market operations were complicated during the period by extraordinarily large federal tax payments in April, which substantially increased the volume of open market purchases needed to offset the reserve drains associated with those tax payments.

Market interest rates generally posted small mixed changes over the intermeeting period. Most private short-term rates increased only a little in response to the March policy action, which had been largely anticipated by market participants. Intermediate- and long-term yields rose over the early part of the intermeeting period, responding mostly to incoming data suggesting that growth in aggregate demand and output remained strong; these increases were subsequently more than reversed, however, as later information indicated that economic growth was moderating and price inflation remained subdued and on news of an agreement to balance the federal budget. Major indexes of stock market prices fluctuated substantially over the period but they rose considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period. The movements of the dollar during the period roughly corresponded to the fluctuations in intermediate- and long-term U.S. interest rates; the dollar advanced strongly in April on growing expectations of a further firming of U.S. monetary policy but more than retraced that gain in May as the likelihood of further tightening waned. The dollar's weakness in May also seemed to reflect growing attention to the prospects for official intervention to restrain the dollar's rise, notably against the Japanese yen and the German mark.

The growth of M2 and M3 remained brisk over March and April. Much of M2's strength during this period resulted from a temporary buildup by households of balances in savings accounts and money market mutual funds to cover unusually large tax payments. The rapid growth of M3 was associated not only with the bulge in M2 but also with stepped-up issuance of large time deposits to fund the expansion of bank credit. For the year through

April, both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. The growth of total domestic nonfinancial debt had moderated over recent months as a result of reductions in federal government borrowing.

The staff forecast prepared for this meeting suggested that the economy would expand in the second half of the year at a rate a little above that of its estimated potential and then would increase at a slower and more sustainable rate in 1998. Growth of consumer spending, supported by high levels of household wealth and further projected gains in employment and income, was expected to remain fairly brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in association with the gradual diminution of increases in sales and profits that was expected to be associated with moderating economic growth. Housing construction was projected to drift lower over coming quarters, partly in conjunction with the rise in mortgage interest rates that already had occurred but also in response to the smaller increases expected in household income. The staff continued to anticipate that fiscal policy and the external sector would exert mild restraint on the expansion of economic activity. With resource utilization high and labor compensation gradually accelerating, core consumer price inflation was forecast to drift slightly higher.

In the Committee's discussion, the members agreed that the information for recent months pointed on balance to a marked slowing in the expansion of economic activity from a very rapid pace in late 1996 and earlier this year. The extent of the reduced growth in the current quarter and the prospects for subsequent quarters were subject to substantial uncertainty, but the members generally felt that the economy retained considerable underlying strength. In the circumstances and assuming no changes from current financial conditions, the individual members saw likely prospects for expansion over the forecast horizon at a pace close to, or a little above, the estimated growth of the economy's long-run potential. Many noted, however, that high levels of consumer and business confidence and supportive financial conditions among other factors suggested the possibility that growth could turn out to be even faster. With the utilization of productive resources, notably labor, already at particularly high levels in relation to the economy's potential, an outcome no stronger than current forecasts could well have adverse implications for inflation. Nonetheless, the members also noted that the rise in compensation increases had been damped and that there continued to be few indications of accelerating price inflation in the statistical and anecdotal information available at this time; such developments underlined persisting uncertainties about behavior in labor markets and the level and growth of the economy's sustainable potential.

In their review of developments in key sectors of the economy, members referred to favorable underlying factors in the outlook for consumer spending, These included solid growth in consumer incomes, large increases in financial wealth, and currently high levels of consumer confidence. While more moderate growth in consumer spending for durable goods seemed likely after an extended period of robust expansion, these favorable factors suggested that the risks of a different outcome were tilted in the direction of faster-than-projected expansion. On the negative side, large consumer debts were still viewed as likely to constitute an inhibiting influence on consumer expenditures, and many banking institutions had tightened lending terms and conditions at least for their more marginal consumer borrowers. On balance, growth in consumer expenditures at a somewhat reduced pace approximating that of the expected expansion of disposable incomes appeared to be a reasonable prospect, though one that was subject to considerable uncertainty.

Spending for business fixed investment seemed to have retained a good deal of momentum even after the large increases in such expenditures in recent years. Clearly, businesses regarded such investments as highly profitable, and they appeared to be leading to gains in productivity that in turn were helping to offset rising compensation and to maintain profit margins in highly competitive markets. In the circumstances, it appeared unlikely that growth in capital outlays would moderate appreciably for some time. A number of members also referred to the increasing strength in nonresidential construction, notably that of commercial structures, in several parts of the nation. Some referred in particular to planned or actual construction of new office buildings in various locales; such activity was being stimulated by declining vacancy rates, rising rents, and a ready availability of financing. Likewise, a surge in tourism in a number of areas had resulted in a scarcity of hotel rooms and was spurring hotel construction in some major cities. Anecdotal reports of nonresidential building activity undertaken on a speculative basis had increased, but a building boom reminiscent of the 1980s did not appear to be under way.

Concerning the outlook for housing, members referred to forecasts of a mild downtrend in residential construction associated with the increases that had occurred in mortgage interest rates. To date, however, there were few indications of any weakening. Indeed, housing construction had been relatively robust in the early months of the year, though the strength probably was largely accounted for by unusually favorable weather conditions and may have borrowed from building activity later in the year. On balance, as evidenced by anecdotal reports from some areas, various factors including ongoing growth in employment and incomes, the availability of financing on still generally favorable terms, and the associated affordability of housing for many homeowners seemed likely to provide continued support for this sector of the economy for some period of time.

A surge in nonfarm business inventory investment accounted for a substantial portion of the acceleration in output in the first quarter, and an anticipated moderation in the accumulation of inventories was an important element in forecasts of greatly reduced economic growth in the current quarter. In keeping with business practices aimed at achieving or maintaining lean inventory-sales ratios, inventory investment was projected to continue at a relatively subdued pace in coming quarters. A number of members expressed the view, however, that stockbuilding represented an upside risk in the economic outlook, at least in the nearer term. While there were some indications of efforts to pare inventories in recent months, generally optimistic business sentiment and currently trim inventories in most industries might well foster efforts to accumulate stocks at a relatively rapid pace, especially if more-buoyant-than-anticipated sales were to stimulate a precautionary demand for inventories as had occurred in 1994.

With regard to the outlook for inflation, members observed that increases in prices had remained subdued despite the rapid expansion in economic activity in recent quarters and the associated increase in pressures on already highly utilized resources. The appreciation of the dollar undoubtedly had helped to damp domestic inflation this year, and reported increases in consumer prices also had been held down to a marginal extent by an ongoing series of technical adjustments to the CPI. These were only partial explanations, however, and the members found it very difficult to account for the surprisingly benign behavior of inflation in an economy that had been operating at a level approximating full employment--indeed, possibly somewhat above sustainable full employment in labor markets in the view of a number of members, especially taking into consideration the recent further decline in the unemployment rate. On the basis of historical patterns, any overshooting of full employment would be expected to generate rising inflation over time. Although increases in labor compensation had been trending higher, these pressures were muted and had not shown through to prices.

Members focused on the possible role of faster-than-reported increases in productivity as a key explanation for the benign behavior of inflation in current circumstances. Business firms had continued to report robust profit margins in a period when competitive pressures generally prevented them from raising their prices, or raising them sufficiently, to pass on the increases that they were experiencing in worker compensation. Standard statistical measures that pointed to relatively limited increases in productivity seemed inconsistent with strong profits as well as with anecdotal reports of sizable gains associated with widespread business restructuring activities and large additions of high-technology equipment to an increasingly efficient capital stock. The ongoing development and spreading adoption of automated equipment along with the increasing skills and other infrastructure needed to use it effectively appeared to be creating growing efficiencies or synergies that were markedly enhancing productivity and enabling firms to hold the line on prices and maintain high profit margins.

While these were welcome developments, members continued to express concern that, perhaps sooner rather than later, growing pressures on productive resources would be reflected in some upturn in overall inflation. Although most measures of labor compensation had been relatively favorable recently, such measures had been displaying a clear uptrend over a somewhat longer period, and it seemed likely that, if this trend continued, labor cost developments would at some point be reflected more fully in core measures of prices. Members commented that the timing and extent of any upturn in price inflation would depend on growth of overall demand in the economy, but they also believed that expansion of demand in line with their current expectations could induce a somewhat less favorable inflation experience during coming quarters. However, recent developments had underscored the fact that historical experience was not a fully reliable guide to the prospective behavior of prices; accordingly, the inflation outlook remained subject to considerable uncertainty.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members indicated that they could support a proposal to maintain an unchanged policy stance, although some also expressed a preference for some tightening at this meeting. Those who endorsed a steady policy at this time agreed that some tightening might well be needed later to contain potentially rising inflation. For now, however, economic growth seemed to be slowing to a more sustainable pace, and the uncertainties surrounding the extent of the slowing and the outlook for inflation pointed to the desirability of a cautious approach to any policy tightening, especially given the persisting absence of a rising inflation trend in current measures of prices. A number of members also observed that real interest rates were not unusually low. Thus, the present stance of monetary policy probably was not very far out of alignment with what likely would prove to be a desirable degree of restraint, thereby lessening any risk of large and persisting imbalances that a delay in implementing further restraint might incur.

Members who preferred some tightening, at least in the near term if not necessarily at this meeting, noted that the Committee needed to weigh the risks of having to implement a small degree of restraint now versus considerably more later if inflation were allowed to build momentum. Monetary policy exerts its effects with a considerable lag, and a small but relatively prompt tightening action would provide some further insurance against an intensification of inflation. Such an outcome could be seen as more likely now, given the increased tightness in labor markets and the possibility that relatively strong growth would put added pressures on resources. Some of these members commented that the risk of a retarding effect on the economy from a small move at this time was quite limited in light of the apparently solid momentum of the economic expansion. Indeed, the strength of investment demand, the ready availability of financing, and possible favorable productivity gains argued that real rates of interest would need to be higher than historical norms to balance aggregate demand and supply. The risk of slightly lower economic growth needed to be compared with what they viewed as the greater risk of losing ground to inflation and thereby inhibiting the Committee's ability to reach its ultimate goal of price stability, a goal that all the members viewed as necessary to achieve maximum sustainable economic growth over time. Given the quiescence of inflation and the uncertainties surrounding its outlook, however, all but one of these members could accept a wait-and-see policy stance for now.

With regard to possible adjustments to policy during the intermeeting period, all the members supported a shift from the symmetric directive that had been adopted in conjunction with the policy tightening action at the March meeting to an asymmetric directive tilted toward tightening. While such a bias did not necessarily imply an intention to tighten policy during the weeks immediately ahead, it was consistent with the members' view that the risks were in the direction of a potential need for some tightening in monetary policy to counter rising inflationary pressures, and that they might be required to make such a decision in the not-too-distant future.

At the conclusion of the Committee's discussion, all but one member indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that included a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The information reviewed at this meeting suggests that growth in economic activity has slowed after surging in late 1996 and earlier this year. Private nonfarm payroll employment increased at a considerably reduced pace over March and April, but the civilian unemployment rate fell appreciably to 4.9 percent in April. Industrial production was flat in April following sizable gains over previous months. Nominal retail sales were unchanged in March and declined in April after a considerable advance in earlier months. Housing activity in March and April was little changed from other recent months. Available indicators point to further sizable gains in business fixed investment. The nominal deficit on U.S. trade in goods and services widened substantially in

January-February from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Market interest rates generally have posted small mixed changes since the Committee meeting on March 25, 1997; share prices in equity markets have risen considerably. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period.

Growth of M2 and M3 was brisk over March and April, boosted by a buildup in household balances to cover unusually large tax payments. For the year through April, both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. Growth in total domestic nonfinancial debt has moderated over recent months, reflecting reductions in federal government borrowing.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin.

Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that the strength of investment demand, due possibly to an increase in the trend growth rate of productivity, required somewhat higher real interest rates to prevent inflationary pressures from developing. He was concerned that, with the economy already operating at a high level and labor markets apparently very tight, any increase in such pressures might be costly to reverse and might reduce the credibility of the Committee's longer-run strategy of promoting maximum sustainable growth by fostering price level stability. He also believed that the risk to the economy of a moderate further tightening was small given the apparent momentum of aggregate economic activity.

It was agreed that the next meeting of the Committee would be held on Tuesday-Wednesday, July 1-2, 1997.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

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